Beer- the ties that bind

Michael Waterson

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Beer- the ties that bind

Michael Waterson[1]
Economics, University of Warwick

*"You're walkin' tough baby, but you're walkin' blind
to the ties that bind"*

Bruce Springsteen

Introduction

It started with the Beer Orders (1989). A watershed decision was made by the Law Lords in July 2006. For one man, Bernie Crehan, this was the culmination of a 15 year episode in the pub trade, in which he has made legal history as the first UK case of damages for breach of competition law being awarded by a court. Possibly hundreds of other cases hung on their Lordships' decision and Nomura, the Japanese bank that took over the chain called Inntrepreneur, had a total potential liability of £100m. And it all concerns Article 81, vertical agreements, and the price of a pint of beer.

In 1989, the UK Monopolies and Mergers Commission published its lengthy and long-awaited report on Beer. The Commission "…recommended measures that eventually led brewers to divest themselves of 14000 public houses. The MMC claimed that their recommendations would lower retail prices and increase consumer choice. There is considerable doubt, however, that their objectives were achieved." (Slade, 1998, p565). In their report, the MMC noted rising real prices of beer and seized upon the power of the then big six brewers exercised through their considerable tied estates as being a prime motor. Consequently, they recommended that the ties be substantially cut. At that stage, the MMC (unlike the present day Competition Commission) did not determine remedies and it was left to the Department of Trade and Industry (DTI) to formulate the remedies (the Beer Orders) and the Office of Fair Trading (OFT) to supervise their implementation. Thus the OFT found itself implementing the Beer Orders in the face of a brewing industry determined to fight back.

In the partial move to unbundled retailing from brewing of beer, some former brewers decided to get out of brewing or retailing altogether. One development was the formation of Pubcos, intervening between brewers and individual licensees. These Pubcos, of which the largest was Grand Metropolitan, took over the ownership of pub chains from brewers but then either managed the pubs directly, or alternatively installed tenants under contracts similar to those tenants formerly had with the brewers. That is, the tenant was an individual entrepreneur, on a relatively short lease, purchasing fixtures and fittings,

[1] I was involved in providing economic advice to a Birmingham firm of solicitors and barristers, Ferdinand-Kelly, which was retained on several cases brought by pub tenants against brewers, including the Bass and S&N cases. However, my arguments were not necessarily accepted by the Commission or the courts and this chapter should be considered to be solely my own opinion. I was not involved at all in the *Crehan* case. I would like to thank Morten Hviid and Margaret Slade for helpful discussions and Bruce Lyons for helpful comments and editing. None of these should be assumed to share my taste in music.

making pricing decisions, and purchasing stock from the pubco or his nominated supplier. Pubcos typically negotiated agreements with brewers for exclusive supply of a particular brand of alcoholic drinks for some long period. then where relevant "negotiated" agreements with their tenants for their exclusive orders of drink. One issue with these latter vertical agreements was whether they contravened (what is now) Article 81.

For example, a tenant subject to an exclusive supply contract has no option to switch if the brewer raises the wholesale price of beer. This was the matter considered in *Crehan*. Underlying it, and numerous similar cases, are several economic issues arising from a fundamental change in the business model of the beer industry, as well as a change in drinking habits in the UK. One remarkable thing is how a case relating to one individual has occupied so much court time, including a significant period in the European Court of Justice, the UK High Court, the Court of Appeal and several days in the House of Lords (June 2006).[2] The reason of course is that larger issues are at stake. Indeed, this case is but one of many similar cases brought by tenants, involving Inntrepreneur and Courage (its nominated supplier), Whitbread, Bass and Scottish & Newcastle, amongst other brewers.

To illustrate the difference between the various business arrangements under discussion, consider Figure 1. Brewer 1 manages pub 1- it sets prices there directly. In pub 2, it has a tenant; that tenant is free to set retail price but is prevented from buying its beer from any but Brewer1. Pub 3 is owned by a pubco, which has signed an exclusive arrangement with Brewer 1; pub 5 is similar but relates to Brewer 2. Finally, pub 4 is a so-called free house, able to buy from either brewer.

In this chapter, I set out the relevant facts relating to the general issue, discuss the main features of the economics involved, plus some of the legal arguments, examine this in the light of key cases and cover some implications.

[2] Indeed, according to press reports, Inntrepreneur's representatives paid £1.4m of Crehan's costs into an account in order that the Lords' hearing went ahead!

The Economic Framework

It is well known that in a vertical linkage relationship with some monopoly power at one or more stages, the interests of players at one stage will not coincide with those at another. For example, if I supply a good to someone, the price they set is probably not the price I would prefer they set to maximise my profits. In fact, if both of us have significant market power, once my margin plus my customer's margin is added to marginal cost, the final price may be above the monopoly level and demand cut back so much that profits could be increased by lowering price. Double or successive marginalisation, as this is called, is usually non-optimal. This clash of interests may be viewed as the result of various externalities in the relationship (Mathewson and Winter, 1984), although calling them externalities should not blind us to the possibility that devices to "correct" them may be anticompetitive. For example, a brewer charging a tenant a premium over marginal cost for beer faces the problem that the tenant may in turn charge a premium over invoice price, thereby curtailing sales of the product in favour of other drinks. Therefore the brewer may wish to impose an obligation that the tenant takes at least a certain number of barrels of beer. This should encourage a lower retail price in order to meet the sales target. More controversially, the brewer may specify that the tenant does not do certain things, like buy soft drinks from other than a brewer- nominated supplier. In practice, arrangements between brewers and tenants have included many restrictions, some of which are pro-competitive (in the sense that they keep final prices down or spread risk) and some anticompetitive. A balance needs to be struck between the parties and between the parties and consumers.[3]

In order to provide a full economic analysis that reflects the essential features of the market, a model needs to incorporate some competition at the supply stage as well as competition at the final stage. The essential economic modelling of the situation is set out in Slade (1998) and derives from Rey and Stiglitz (1995). A version of this analysis is set out in Appendix 1 because, although straightforward, it is somewhat technical. A heuristic account appears below, building up from a simpler framework which begins by assuming a monopoly brewer.

Consider three alternative scenarios. For simplicity, each focuses entirely on (a single) beer as the product. Consider initially that there is a monopoly supplier of beer- the brewer. In the first scenario, the brewer is vertically integrated with its pub chain. The second has the brewer selling entirely to the many individual pub-owners. In the third, the brewer sells to a Pubco, who sells on to pubs.

It is well established that the optimal arrangement in the first case is for the brewer to price the input, beer, between divisions at marginal cost and to make its monopoly profit at the final level.[4] In scenario 2, the brewer alternatively takes its monopoly profit at the upstream production level and sells beer expensively to the pub-owners. Hence, under

[3] See e.g. Dobson and Waterson, 1996, for further discussion on the general issue.
[4] This conclusion does rely very much on the assumption that the supplier does not face much competition. If competition is intense, it may be optimal from the firm's viewpoint to raise price above marginal cost see e.g. Bonanno and Vickers (1988).

reasonable assumptions, there is no difference between the outcomes in these cases. Specifically, one has a marginal cost transfer at the upstream stage, followed by monopoly pricing downstream (with a markup enforced on its managers by the brewer's price list), the other has a monopoly transfer at the upstream stage, followed by marginal cost pricing. If there is no possibility of substituting cheaper drinks at the downstream stage, the monopoly profit is taken in each case, and it is a matter of accounting within the brewer how this is allocated. This is optimal both in the sense that it improves the brewer's profit and in that it is best for consumers, given that the brewer has a certain market power. If in the second scenario there is a possibility of substitution downstream, the brewer would be likely to impose arrangements that minimise this, for example requiring the pub-owner to take a minimum quantity of beer, or requiring the pub-owner to purchase other items such as wines and soft drinks from itself also.

The third scenario is somewhat different. Here there is a clear danger of successive marginalisation. The brewer raises its price to the pubco above marginal cost. The pubco in turn adds on a margin, so setting a higher price to the pub-owner than under either of the previous situations. The pubco's tenant, if there is one, may then add a third margin. This leads to lower total profits for the brewer and pubco taken together, with the added problem of higher consumer prices, unless the brewer and pubco bargain in a more sophisticated manner, recognising their mutual as well as opposing interests.

Of course, individual breweries do not exist in a vacuum. The model analysed in the appendix takes account of this by adopting a framework where there are two brewers, either selling into the free market (i.e. independently owned pubs), or selling to managed pubs of their own, or selling to tenants, or selling to pubcos under exclusive contracts. It must be admitted that in order to solve the model straightforwardly, a good deal of symmetry as between the firms is assumed. The outcome is as follows. The free trade and managed house (vertically integrated) scenarios lead to essentially the same result as each other, with a relatively low price. This is driven by downstream competition.

In the case where the brewer sells to tenants a price somewhat above this results. Recall that a tenant sets her own retail price whereas a manager has little pricing discretion. Here, a new force comes in, not present in the monopoly situation considered earlier. The tenant will add a margin on to wholesale price. The brewer raises wholesale price above marginal cost in such a way that the tenant sets a final price which is optimal from the brewer's point of view, given that the competition faced by the tenant. The brewer recognises that it faces a tradeoff between making a big margin on the beer it sells, but selling less beer given the competition between its tenanted pubs and the other brewer's pubs, and setting a lower margin but selling more beer.

Finally, consider the case of a pubco chain. Here there could be two successive contracts, between brewer and pubco, and then between pubco and tenant. Therefore conceptually, we could analyse the pubco- tenant relationship along the lines used analysing the brewer- tenant relationship, but then incorporate the margin added on by the brewer in selling to the pubco. Note that the brewer cannot capture profit from the pubco via a fixed fee, so that double marginalisation is likely in any case. This scenario leads to the highest prices amongst the various possibilities because of successive marginalisation, without the brewer being able to optimise the retail price.

Slade (1998) extends this model to show that

$$p^{chain} \approx p^{leased} \succ p^{tenanted} \succ p^{free} ? p^{managed} \succ c \qquad (1)$$

We may now see that there is a problem for a competition authority wishing to intervene in the market to get prices down. Reducing the number of tenanted houses will lead to a lowering of final prices in the market if the formerly tenanted pubs become free of tie. However, if the pubs are instead bought up by pubco chains, the clear danger is that the situation is worsened- prices rise on average rather than falling.

One of the implicit assumptions underlying all this analysis is that there is a paucity of competition in the brewing market. In addition, in order for pubcos to exist, they must not face too much competition with other channels of supply that would plausibly lead to lower beer prices for consumers.

The modelling here, as Slade explains, assumes in each case that the equilibrium involves a single contract type. Manifestly, this is untrue in the context of beer. Nevertheless, by modelling the simplest situation within the final sector, we can postulate likely outcomes in mixed situations.

Consider then a final market differentiated duopoly (e.g. two nearby pubs). Demand is symmetric, but one of them faces higher marginal cost of its input (beer). Marginal cost is constant in each case. Equilibrium is reached through price-setting behaviour. Straightforward algebra (sketched in Appendix 2) shows that the firm charged the higher input price charges a higher final price, sells less than the other firm, and obtains lower gross profit. Intuitively, the higher input price puts the firm at a disadvantage- it faces a tradeoff between raising price thereby cutting its own demand and reducing its margin. Therefore, profits accordingly are lower.

Nevertheless, two (or more) players can easily co-exist in the market, so long as there is differentiation between them. Moreover, if the one facing higher variable costs also faces lower fixed costs (e.g. rent), its net profit need not be lower. Hence, a potential publican choosing between contracts, one of which implies a higher beer price but a subsidised rent, the other the possibility of discounted beer but a full rent, might choose either one depending on the precise contracts offered. Indeed, the former probably exposes the publican to less risk, and may be preferred even if the earnings stream has a lower mean (an argument made by Yarrow in MMC *Beer*) Thus, someone with limited business experience might be drawn to a contract that promises a smoothed return. In this case, a lower rent is an example of what is later referred to as an ‘offsetting benefit’.

On the other hand, a tenant facing both a higher beer price and a rent appropriate to a pub free of any tie would naturally earn a lower net profit than an otherwise equivalent pub either being charged a lower price for beer, or being charged a lower rent.

In respect of calculations of damages discussed later on, note that if particular premises have a pub licence, the value is likely to be higher as a public house than as a dwelling because licences are in limited supply. A plausible way to value the pub would be the discounted stream of earnings net of the labour costs etc involved in generating those earnings. However, the earnings themselves will depend on the prices charged for key inputs. Thus the value of a pub "in the open market" is not in theory determined unless the contract under which key inputs to the pub are supplied is specified. Value as a free house is likely to be higher than value under a supply tie. This conclusion appears to be accepted by experienced valuers of public houses (for example it becomes evident in Justice Park's thinking in the High Court in *Crehan*).

Legal analysis

The legal analysis of cases of this type (specifically, contacts between brewers and publicans or pubcos and publicans) takes on a particular form, but is clearly informed by economic considerations. The essential question is whether the arrangements struck between brewers/ pubcos and tenants fell within the law. If an agreement is found to contravene competition law, it is invalid. Moreover, although the (English) High Court ruled at one stage that a party to an agreement could not claim damages as a result of the agreement being unlawful under Article 81, the European Court of Justice (ECJ) determined that a party to an agreement could obtain relief. Thus, in principle the way is clear for a private action for damages.

A large number of cases have been through at least some stages towards a claim for damages as a result of infringement of Article 81. A particular structure has built up, based upon a key EU case, *Delimitis*, relating to a German pub. This was decided by the ECJ, which is the highest European court that hears competition cases and so it sets an important precedent. This case in turn followed an earlier EU judgement in *Brasserie de Haecht*, a Belgian bar. A key point established in these and similar cases is that, although a particular agreement between a brewer and a pub is of trivial significance for the European Community as a whole, the consequences of that agreement are nevertheless non-trivial. Any such agreement cannot be viewed in isolation, because it is likely to be just one example amongst a large number of similar agreements imposed by one party, which have a consequential impact upon competition in the market. For example, if there are 100 feasible outlets for a particular product, and one producer of that product has signed up exclusive deals with 98 of them, then it can be fairly concluded that the market is foreclosed to new entrants and that the established producer is maintaining a monopoly as a result of the agreements, although any particular instance of this agreement has a very small contributing influence to the overall effect. Similarly, if there are three producers, who have signed up respectively say 50, 30 and 18 outlets, the market would be foreclosed to entry, although dependent upon the nature of the distribution of outlets, competition between the three players would differ in its impact[5].

[5] For example, if the 50 are in England, the 30 in Scotland and the 18 in Wales, in effect a monopoly still exists assuming people do not travel far for the product.

The *Delimitis* precedent requires the competition authority to jump over a series of hurdles, set out diagrammatically in figure 2, before an agreement is considered illegal. The first is whether the market can be considered foreclosed by the contracts, or entry significantly impeded by other factors. At the time of the relevant cases in the UK, the early 1990s, the on-trade channel constituted 81% of total beer sales, with price movements distinctly different from the off-trade, therefore arguably constituting a separate market. Brewers were in control of over 90% of the distribution and wholesaling of beer in the UK and to a significant extent operated through exclusivity agreements. Pub licences were limited by local magistrates and were a significant barrier to the entry of new pubs. Of course, a number of these things have now changed, in part as a result of the Monopolies and Mergers Commission report on Beer in 1988, but at the stage of the actions we are considering, brewers were arguably trying to hold on to their market power through variations in the original restrictive agreements that the competition authorities might be prepared to allow. Specifically, although the major brewers were forced to divest large numbers of pubs, they negotiated long term exclusive agreements with the pub chains that resulted. (Slade, 1998). In any event, the European Commission (DG4) determined in a number of decisions that the market was foreclosed at that time. This entry barrier test is known as the "Delimitis 1" test.

Assuming the market is foreclosed, attention passes to whether the set of agreements of which the agreement in question is part contribute to the foreclosing effect. Essentially, this is seen as dependent on the significance of the set of agreements. A small brewer with a handful of pubs would be most unlikely to be seen as contributing, whilst a large market player with many thousands of pubs would likely be deemed as contributing. This significant effect test is known as the "Delimitis 2" test.

Nevertheless, vertical agreements may qualify for a Block Exemption under Article 81(3). Here, the law has changed somewhat, but at the time of the cases under discussion there was a specific block exemption for vertical agreements in the beer industry. If agreements were in a particular form, then they would satisfy the block exemption and would be allowed.

In practice, the agreements drawn up by brewers commonly did not satisfy the block exemption, because they were too broad (not specifying the products, or including products apart from beer), too long (e.g. for an indefinite period), or too unspecific. Nevertheless, a brewer could still apply for individual exemption under Article 81(3), if the agreement was viewed as providing benefits offsetting the restrictions applied by the agreement.

If the agreement does not escape under any of the above possible routes, then it contravenes Article 81, and is therefore void. Matters then turn on whether and how the tenant has been harmed by the agreement and the potential for damages to be claimed by the tenant.

Specific Cases

A number of cases have been through this process. For example, in *Greene King*, the tenant fell foul of *Delimitis* 2. Greene King is a regional but not a national player (it was designated as regional in the MMC report), so its agreements were not viewed as significant enough to contribute to foreclosure. Three National brewers, Whitbread, Bass and Scottish & Newcastle were each involved in very similar cases before the Commission. In each case, the tenant's arguments were accepted, to the extent that they passed the *Delimitis* 1 and 2 tests and none of the agreements qualified for block exemption. However, in each case, the brewer applied retrospectively for individual exemption, using the argument that they had provided sufficient offsetting benefits. In each case, this was accepted, so the cases fell at this hurdle.

Offsetting benefits in Bass

It is interesting to examine the arguments underpinning the "offsetting benefits" analysis from an economist's viewpoint. We take the case of Bass, because it is well documented.

The Commission granted individual exemption to Bass from the provisions of Article 81 in respect of its agreements with tenants (retrospectively) from March 1991 to December 2002. Individual exemption is allowed if there are significant benefits in distributing the product. The Commission view beer supply agreements as having the potential to lead to such improvements in distribution (paragraph 168; subsequent bracketed numbers also refer to paragraphs in this judgement) and indeed it is easy to see that there are some potential benefits. (This is not to say that a beer supply agreement is the only, or even the most efficient, means of securing such benefits.) Logically, however, the benefits will not materialise if the typical tenant is forced into unfavourable terms of business so as to be placed at a competitive disadvantage. It is clear that tenants pay more than free market prices for their beer, which does place them at a disadvantage. However, they receive inducements as a result of signing a tenancy agreement. Thus the question turned on whether the inducements sufficed to place the tenant on a "level playing field" (176). The Commission concluded that on average "the price differential is more than compensated by quantifiable countervailing benefits" (186) and hence that the leases qualify for individual exemption under 81(3).

Let us examine this proposition.[6] The Commission acknowledges that "A brewer might … decide to 'cash in' on his leverage vis-à-vis his tied customers." (174); e.g. by raising wholesale beer prices without increasing offsetting benefits. On the face of it, this is exactly what Bass did. In the Commission's Table 3 (108) [extracted in Table 1 below] we see the price differential between tied and free trade going from £19 to £48 per barrel in regularly increasing intervals over the period from 1990/91 to 1996/97. Thus in order to justify an exemption, it is necessary to argue at least that the quantifiable benefits to tenants have increased regularly over the period. The major means by which this is demonstrated are that (i) rent subsidy has increased over the period, (ii) value added services have increased in value, (iii) a support franchise scheme has been instituted and

[6] The Commission did not accept the arguments that follow, or at least the implication drawn from them.

(iv) promotions have increased in value. If none of these had occurred, on the figures in the Table, a conclusion of a positive benefit in 1990/91 of £3 would have moved to a negative benefit (i.e. disbenefit) of £24 by 1996/97 and it is extremely unlikely that individual exemption would have been granted. We therefore need to look more closely at the value of the offsets.

Consider first the question of rent. It is difficult to establish what is the subsidy to rent afforded the tenant compared with the free market rental of the pub if "free of tie", since this requires establishing a counterfactual. What is the 'un-tied' rent? The Commission use a figure of 15% as the average free-of-tie rental to income ratio and 11.36% as the average rent paid for a pub in the tenanted estate (64, 65).[7] Pubs differ in their attractiveness and costs, so any average figure disguises some necessary variation. It would be impossible to take account of all sources of such variation, but one significant issue suggests itself. Essentially, the Commission is making the implicit assumption that the tenanted houses are in effect a random sample of the premises the brewer owns. If they are not, if for example they are on average smaller or less well situated, we might envisage that a lower ratio of rental to turnover might be what the market would command on account of a lower profit margin. There is a second point. The figures of 11.36% and 15%, giving a subsidy of 3.64% of turnover, presumably must be applied to each year, i.e. the subsidy as a percentage of turnover is assumed constant. However, when converted into a subsidy per barrel equivalent, for Table 1, this results in an increasing figure which has a significant impact on the final figures. If, with nothing else changed, the rent subsidy were held constant in per-barrel terms over the period, the conclusion would be a negative figure for rent subsidy from 1992/93 onwards.

Secondly, consider value added services. There is a significant difference of viewpoint between Bass and many of its tenants regarding the value of the services gathered under this head. Again, two points. First, in its judgement, the Commission reduced by 25% the value as perceived by Bass of these benefits. However the overall calculation is rather sensitive to this percentage. If the reduction were to be 50% not 25%, then in 1996/97, the overall balance of beneficial effects to the tenant in table 1 would be negative, and the balance over the last seven years would be negative on average. This would lead to a very different view being taken on the balance of advantage in the tenancies and so also on the individual exemption afforded to Bass. Second, the figures are very sensitive to particular assumptions which may be erroneous. One may accept that the terms negotiated by Bass with suppliers of products such as glassware and insurance for their tenants' use can be regarded as a base point for price discussions elsewhere. Yet, is this a benefit which might be equated with a continuing, indeed rising, offsetting effect on beer prices? Many of the activities described under this head might be best thought of as providing knowledge. Once knowledge has been gained, it can be used freely without limit. Thus, to equate this benefit with an *increasing* offsetting benefit per barrel seems most peculiar, even if the range of information provided over

[7] Here we see a very curious coincidence- the figure of 11.36% obtained "from internal Bass documents", is *precisely* the same as the figure quoted as arising from a "sample of S&N tied houses selected by the Commission..." (*S&N* Decision, at (65)). This suggests either that an industry norm has been established by some means or that there is some confusion concerning the source of this 11.36%.

time does increase.

Thirdly, consider promotions: Here we have a classic problem in a vertical relationship. One party wishes to promote products and both parties benefit. It is clearly misleading to say that "These promotions are intended to increase the turnover of the individual lessee." (104) They are intended to benefit both parties, irrespective of whether they are exclusive to lessees or not. If we, somewhat arbitrarily, assigned the benefit half to tenants, half to Bass, this by itself would be enough to make the net conclusion over the last six years in table 1 negative. Again, the outcome is seen to be extremely sensitive to the precise assumption made.

Finally, the agreements relate to beer, and the Commission focus on the effect on beer. However, when examining offsetting benefits, another, perhaps crucial, side to the coin must be examined and another range of issues opened up. Are there other costs imposed on tenants as a result of their relationship with Bass which have not been taken into the equation? For example, does Bass impose restrictions or purchasing requirements on other drinks, crisps and the like which may be at above market prices? If offsetting benefits are to be brought into the equation, clearly offsetting costs must also be, in order to examine the complete picture.

Does Crehan jump the hurdles?

The Inntrepreneur- Crehan case (hereafter, *Crehan*) is by far the best known amongst the cases under review, and has some significant differences from the brewer cases discussed above. Bernie Crehan was a tenant of Inntrepreneur, a pub company, who in turn had an exclusivity arrangement with Courage, the brewer, regarding supplies of beer to their pubs. The case relates essentially to Crehan's relationship with the pub chain, not the brewer, although there was a preliminary judgement concerning the link with the brewer. Inntrepreneur pioneered a novel type of lease, which appeared initially to find interest amongst prospective tenants through being assignable, but later led to widespread complaints, such that Crehan was being treated as a test case for possibly hundreds more similar ones. Crehan himself had been persuaded by Inntrepreneur to take on the leases of two adjacent pubs, The Phoenix and The Cock Inn, in July 1991. He went bust in 1993, claimed this was due to the high wholesale price of beer he was forced to take, preventing him from competing with other local pubs. He sued Courage, (then a parent of Inntrepreneur) for damages in the English High Court, which dismissed his complaint. Following a period in the ECJ relating to an important technical legal point, the case was referred back to the High Court where Justice Park rejected his case, he appealed and his case was accepted by the Court of Appeal. It then went to the highest court in the land, the House of Lords, for final judgement.

The clearest brief summary of the hurdles through which the case needed to pass is provided by the Court of Appeal in their judgement. To use their words, the issues before Justice Park in the High Court were the following:

(1) Is Delimitis condition 1 satisfied?

(2) Is Delimitis condition 2 satisfied?

(3) Does the Block Exemption apply?

(4) Is it an abuse of process for Inntrepreneur to contend that there was no infringement of Art. 81 and that the Block Exemption applies?

(5) Does Mr. Crehan share responsibility with Inntrepreneur to such an extent that Mr. Crehan's claim could not succeed?

(6) Are the damages claimed by Mr. Crehan in respect of a type of loss against which he is protected by Art. 81?

(7) Did the beer ties cause Mr. Crehan's business failure at The Phoenix and The Cock Inn?

(8) What is the appropriate quantum of damages, and at what date should the damages be measured?

Some of these points need further explanation in order to appreciate their significance.

First, was the market foreclosed? Park J (High Court) said not (and was dubious about (2), the contribution of Inntrepreneur to any foreclosure), but on earlier occasions, the European Commission (in Whitbread, Bass and S&N, 1999) had said yes to (1), and, for those firms, (2). For example in *Whitbread*:

> "[The] tying agreements, … have … the cumulative effect of considerably hindering independent access to that market, for new national and foreign competitors"

> "Whitbread's tied sales, of which the notified agreements are a part, contribute significantly to the foreclosure of the UK on-trade market"

Park's decision left the Court of Appeal "profoundly uneasy". They followed the precedent set by the Commission, citing the "principle of sincere cooperation". Note that the Commission had declined to rule on whether Inntrepreneur itself contributed to the foreclosure effect they had observed, because by the time it came to consider it, the matter was of only historic interest. But it is important to note that at the relevant time Inntrepreneur had not managed to satisfy 81(3), nor individual exemption, although it did so later. For later reference, Table 2 extracts some of the relevant details concerning the sizes of the various pub estates.

Park J had considered the nature of the leases caused Crehan's business to fail. So *if* Crehan had passed (1) and (2), he would have been awarded damages

Justice Park determined, after evidence, that Delimitis 1 was not in fact satisfied in the UK in 1991 and shortly thereafter. This might seem directly contrary to the decisions of the Commission in *Whitbread* et al. that the relevant United Kingdom market was foreclosed to the extent that it would have had to be for Delimitis condition 1 to be satisfied. As the Court of Appeal says (para. 74):

> "We are left profoundly uneasy by the judge's approach to the evidence. It is apparent from what the ECJ said in Delimitis that a comprehensive investigation and evaluation of a complex economic situation needs to be conducted before it can be determined whether or not Delimitis condition 1 is or is not satisfied. The judge rightly acknowledged (in para. 159) that he could not possibly embark on a detailed research investigation himself and that to do so would be inconsistent with the role of a judge in civil litigation in this jurisdiction. That is why such investigations have been entrusted to bodies such as the Commission, the MMC or Competition Commission and the OFT."

For this and other reasons, they concluded that the judge erred in law and that he should have held that Delimitis 1 was satisfied. The English court owed a duty of "sincere cooperation" to the European Commission.

Despite being of the opinion that the case should have fallen at the first hurdle, Justice Park usefully argued each of the other points more or less fully in his judgement. He spent relatively little time on Delimitis 2, but suggested the case would have fallen at this hurdle also. The Court of Appeal disagreed, "Again, in our judgment, the judge did not give due deference to Commission decisions. In the Whitbread, Bass and Scottish & Newcastle decisions the Commission had found that smaller tied estates had made a significant contribution to the foreclosure. A fortiori the Inntrepreneur tied estate must have satisfied that test." (para 116).

It was fairly apparent that the agreement did not qualify for block exemption, and that individual exemption would not have been granted (at that time), because there were little in the way of offsetting advantages in exchange for the tie, by comparison with the Whitbread or Bass examples. Nor was it the case that Crehan bore significant shared responsibility, since he was offered a standard form lease as opposed to one purpose negotiated for his own situation.[8] Point (4) is a technical issue that need not detain us. Point (5) is in effect covered below.

Point (6) is a matter of more substance, both from an economic and a legal perspective. Crehan's problem was that the conditions of his lease and tie meant he could not compete on an equal footing with competitor pubs in the locality and that this was what caused his venture to fail. But Article 81(1) applies to distortions at the distribution stage, not at the retail stage. If he had been a prospective entrant into beer distribution, it would have harmed him. So is it valid to argue that he was harmed at the retail stage by a vertical agreement that was illegal under Article 81(1)? Clearly, the economic effect of the

[8] Apparently, this is a novel legal point, where the ECJ had made a ruling that conflicted with a previous Court of Appeal decision, see Whish (2003, pp291-292).

agreement was to make his offering uncompetitive with free-of-tie pubs' offerings. Moreover, the ECJ had previously expressed its view in a part of the case remitted there that Crehan's claim was valid in this respect. Therefore, although English law might well not allow the claim, Community law takes precedence.[9]

Whether the beer ties are what caused, or what substantially contributed to Crehan's business failure cannot ever be known with certainty. However, had he run a manifestly badly managed operation, that would have been evidence against him. As it happens, although he was clearly a somewhat inexperienced businessman, the pubs appear to have generated plenty of witnesses to speak up for him, and his wife's cooking! So, to a reasonable degree of certainty, this aspect can be treated as demonstrated as accepted.

How much was Crehan damaged?

Finally then, there is the question of damages.[10] It must have been somewhat galling for Bernie Crehan to learn that, had Justice Park accepted his representatives' arguments on *Delimitis* 1 and 2, he would have made Crehan a millionaire (£1.3m, actually). The Court of Appeal awarded a more modest sum, around 1/10th of that, but at least they did award something. How is it that two courts come to such a different view on what lawyers call "quantum"?

The Court of Appeal's starting point is

"that sum of money which will put the party who has been injured, or has suffered, in the same position as he would have been in if he had not sustained the wrong for which he is now getting his compensation or reparation." (Livingstone v Raywards Coal (1880).

This approach seems to commend itself both in terms of law and economics.

However, there is a fundamental difficulty in calculating damages in a case such as this. They relate to the "hypothetical profits of a hypothetical business", in the words of the Court of Appeal. If someone sustains an injury at work, it might be reasonable to assume they would otherwise have continued to work normally on the set salary or wage. So it is the hypothetical earnings of a real activity. In the *Crehan* case, the appropriate assumption is that the hypothetical business consists of Crehan running the two pubs free of beer tie. So then if his beer costs were lower, he would set lower prices and gain more custom. Despite the difficulties fraught with evaluating how much exactly this would amount to, the two sides eventually agreed not to challenge the argued presumption that the lost profits between the dates the premises were tenanted and the dates of surrender (two years later) would be £57,121, no doubt a figure which looks spuriously accurate.

[9] This is sometimes called the principle of the Effectiveness of Remedies: A difference between English Law and Community Law here means that if English law were applied, no remedy would be available, which would be contrary to the spirit of the community law allowing damages, which means that English law has to be dis-applied.

[10] See chapter 6 by Peter Mollgaard for a discussion of damages in relation to a cartel.

The second question regarding the business is- how long would he have run it for? Here the High Court took the view that it would have continued until 2003, the date of the action in that court. The Court of Appeal cited previous authority to the effect that it should be presumed in operation until the date the leases were given up, 1993. Beyond that point, it becomes even more questionable what is being valued- would he have given up the leases had he not been subject to the tie? It is essentially impossible to judge. But this is the main source of difference in the two alternative approaches to quantum. The normal legal view is that damages are those suffered at date of loss, i.e. in 1993.

The other main element in the calculation is the consideration he would have obtained from reassignment of the leases. Industry experts considered that a figure of 2.5 times the "maintainable net profit [per year] after rent to include the value of the trade inventories", calculated as £25,186 per year across both pubs. Including "marriage value" (£4,500 per year, again multiplied by 2.5) of the two pubs, this amounts to £74,215, to be added to the £57k noted earlier. It is unclear whether all expenses of employees (for example, managers) have been deducted to render this true economic profit, but on the other hand the 2.5 multiple presumably takes some assumption about this into account. The sums would bear interest.

Hopes Dashed

However, celebrations following the Court of Appeal decision were short-lived (short-lived, that is, by comparison with the glacial pace of the case generally). Inntrepreneur appealed to the House of Lords, who heard the case in June 2006. There seems to have been some genuine uncertainty about the issues on which the Lords would focus. For example, some surprise was expressed that they had not wished to hear arguments on quantum. There was also a distinct possibility that they would have remitted aspects of the decision to the European courts, possibly the point that was determined by the Court of Appeal "without perfect EU authority", point (6) above.

Nevertheless, in a scene reminiscent of Puccini's "Tosca", the House of Lords crushed the case at the final stage. Operatics aside, it is worth dwelling on the reason. Essentially, they took the view that Justice Park had not been in error in putting relatively little weight on the EC decisions in *Whitbread* et al. that the market was foreclosed, and relatively greater weight on the witnesses (including economists) he heard explaining the points. [11] This was because the EU decisions did not relate to Inntrepreneur itself, only to that set of brewers, starting with Whitbread, whose cases were considered. Thus the Lords took the view that the Court of Appeal should not have taken the Commission's decision on the Whitbread case as precedent but rather that Justice Park's decision on Delimitis 1 should stand.

[11] Note that although both systems are adversarial, this is very different from the US system whereby the DoJ takes a competition case to court. The witnesses arguing Crehan's case were not those who had carried out the investigation- they were merely interpreting the results of that investigation and may even have differed on details. Hence they might well be seen as at a disadvantage compared with those experts for Inntrepreneur putting forward their own views.

To my, clearly non-expert, eye this seems a curious decision. The "principle of sincere co-operation" would seem to me to suggest that if in the other cases the *industry* is viewed as foreclosed, then the UK courts should follow that judgement.[12] It was a judgement, made at a relevant time period, by an expert investigative team. Therefore, in my view, it appears at odds with this principle for *Crehan* to fall at Delimitis 1. What might be more arguable is whether *Crehan* should fall at Delimitis 2, because this is the element to which the Principle need not apply. Although Inntrepreneur had more pubs under its control than say S&N (see again table 2), it is a pubco not a brewer and its arrangements with a particular brewer, although several years long, are not perpetual. This issue has not been examined fully in any of the *Crehan* cases cited.

Final Comments

Crehan was the first case in which an English court awarded damages concerning a claim relating to a breach in competition law. Thus, although damages were not eventually paid, the case is of historic interest. The law relating to beer supply arrangements has now changed, so is the case of relevance still or is it, as some say disparagingly, only of academic interest?

I would argue the case is important. As the law now stands, no tenant has received damages in court through this series of actions. One might view the *Crehan* case as a victory of English law over European law, or a victory of law over economics- the legal process of cross-examination of witnesses over the Commission's approach of evidence gathering and summary. But it is a defeat for those contemplating private action in competition claims.

At a more personal level, the people involved as tenants in this series of actions against owners have suffered through an extremely slow, drawn-out and desperate process. Maybe some were foolish, but several have found that they fought one form of tie, to a particular brewer's beer, only to be bound by another, to a legal process which, in Crehan's case, lasted 13 years.

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[12] For example in *Bass* we read "Conclusion on the first Delimitis test …an examination of all tying arrangements, included but not limited to beer- supply agreements entered into, and the other factors relevant to the economic and legal context of the UK on-trade market shows that the brewers' tying arrangements had in 1990, and still have today, … the cumulative effect of considerably hindering independent access to that market, for new national and foreign competitors." (3.3 at para 144).

Appendix 1

The Rey and Stiglitz (1995) vertical arrangements framework

Notation: Upper case letters refer to Upstream values, lower case refer to downstream. The letter p (*P*) is used for prices, *c* for marginal cost, *D* for the demand function, $\pi\,(\Pi)$ for profit and ε for elasticity of demand. Superscripts are used to distinguish between the two producers' products, 1 and 2, with subscripts used for partial derivatives. Superscripts are also used to distinguish different scenarios.

There are two products, one from each producer, with final demand being $D^i(p^1, p^2)$; complete symmetry is assumed (e.g. $D^1{}_2 = D^2{}_1$)

The benchmark case:

Direct producer competition: Firms will choose prices to maximise

$$\Pi^1 = (p^1 - c).D^1(p^1, p^2)$$

Two-stage games:

1. No vertical arrangements- we superscript this case as *c*. Intra-brand price competition leads to zero markups in the second (retail) stage, so that $P^c = p^c$. Thus there is simply competition between the brewers. We may derive:

$$\frac{p^c - c}{p^c} = 1 \Big/ \varepsilon^1(p^c, p^c)$$

2. Exclusive contracts, superscripted *E*:

This is the case where each brewer sells its beer exclusively to a particular pubco, so these are somewhat distinctive. Each pubco by assumption has monopolistic power over some fraction, say θ, of the final demand for each product. As a result, it can charge a markup over input price. This will lead to second-stage retail prices $p^{iE}(P^1, P^2)$
Where

$$\frac{p^{1E} - P^{1E}}{p^{1E}} = \frac{1}{\varepsilon^1}$$

At the first stage, price P^1 is chosen to maximise:

$$\Pi^1 = (P^1 - c).D^1(p^{1E}(P^1, P^2), p^{2E}(P^1, P^2))$$

and similarly for 2. Thus:

$$D^1 + (P^1 - c)\left[D_1^1 . \frac{dp^{1E}}{dP^1} + D_2^1 . \frac{dp^{2E}}{dP^1} \right] = 0$$

Hence, after simplification and symmetry:

$$\frac{(P^E - c)}{P^E} = 1 \Big/ \left[\varepsilon^1 (p^E, p^E).\rho^1 (p^E, p^E) + \varepsilon^2 (p^E, p^E).\rho^2 (p^E, p^E) \right]$$

Here, ρ_1 and ρ_2 are the elasticities of a given retailer's price to its producer's and the other producer's wholesale prices. We may expect that

$$1 > \rho^1 > \rho^2 > 0$$

3. Tenancy arrangement with fee transfer, superscripted *T*. This is the situation where the brewer has a tenant in place in the pub, again with exclusive dealing.

Now the brewer wants to set the optimal final price, so maximises:

$$\Pi^1 = (p^1 - c).D^1 (p^1 (P^1, P^2), p^2 (P^1, P^2))$$

Thus:

$$D^1 \frac{dp^1}{dP^1} + (p^1 - c)\left[D_1^1 \frac{dp^1}{dP^1} + D_2^1 \frac{dp^2}{dP^1} \right] = 0$$

Therefore:

$$\frac{p^T - c}{p^T} = 1 \Big/ [\varepsilon^1 + \varepsilon^2 . \rho^2 / \rho^1]$$

Hence, by comparison with earlier expressions for the markup,

$$p^E \succ p^T \succ p^c$$

We can see that double marginalisation raises price above p^T.

Slade extends this framework to show that:

$$p^{chain} \approx p^{leased} \succ p^{tenanted} \succ p^{free} ? p^{managed} \succ c$$

which is equation (1) in the text.

Appendix 2

Modelling a duopoly with dissimilar costs:

Using a notation essentially the same as in Appendix 1, suppose demand for product *i* is given by:

$$D^i = D^i(p^i, p^j) \quad \text{where } D_i^i < 0, \left|D_i^i\right| > D_j^i > 0 \;\; i, j = 1, 2; i \neq j$$

and further that the demand functions are symmetric.
Suppose marginal cost is c^i, c^j respectively; $c^i > c^j$, without further loss of generality.
Profit is defined as

$$\pi_i = (p^i - c^i)D^i - F^i$$

where F refers to fixed costs, which were earlier ignored, and similarly for firm *j*. We might expect that $F^j > F^i$.

Straightforward maximisation with respect to price, treating the other player's price as given, yields

$$p^i{*} = c^i \big/ (1/\varepsilon^i - 1)$$

where ε^i is the own price elasticity of demand, written as a positive number. Hence, if $\varepsilon^i = \varepsilon^j$ (>1) then $p^i{*} > p^j{*}$. Moreover, from the form of the demand function, $q^i{*} < q^j{*}$. Maximised profits can be written as

$$\pi^i{*} = p^i{*}q^i{*}/\varepsilon^i - F^i .$$

Since demand facing *i* is by definition elastic, revenue declines as price rises, so that if $\varepsilon^i = \varepsilon^j$ then profits gross of fixed costs and sales are larger for low cost *j* than for *i*, and price is lower.

These expressions lead directly to the statements made in the text regarding relative magnitudes of price, quantity and gross profit.

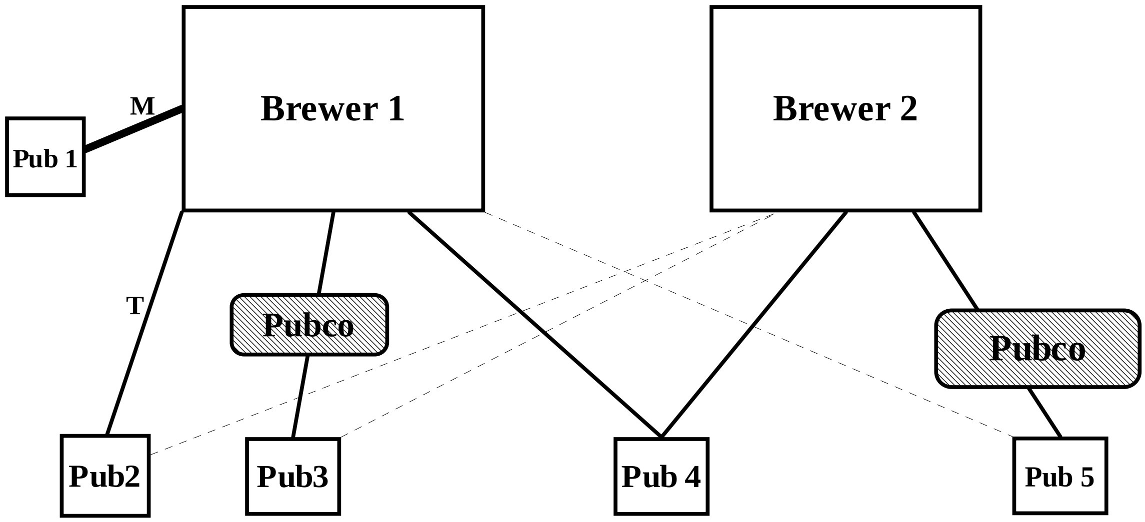

Figure 1: Conceptual framework of the beer industry

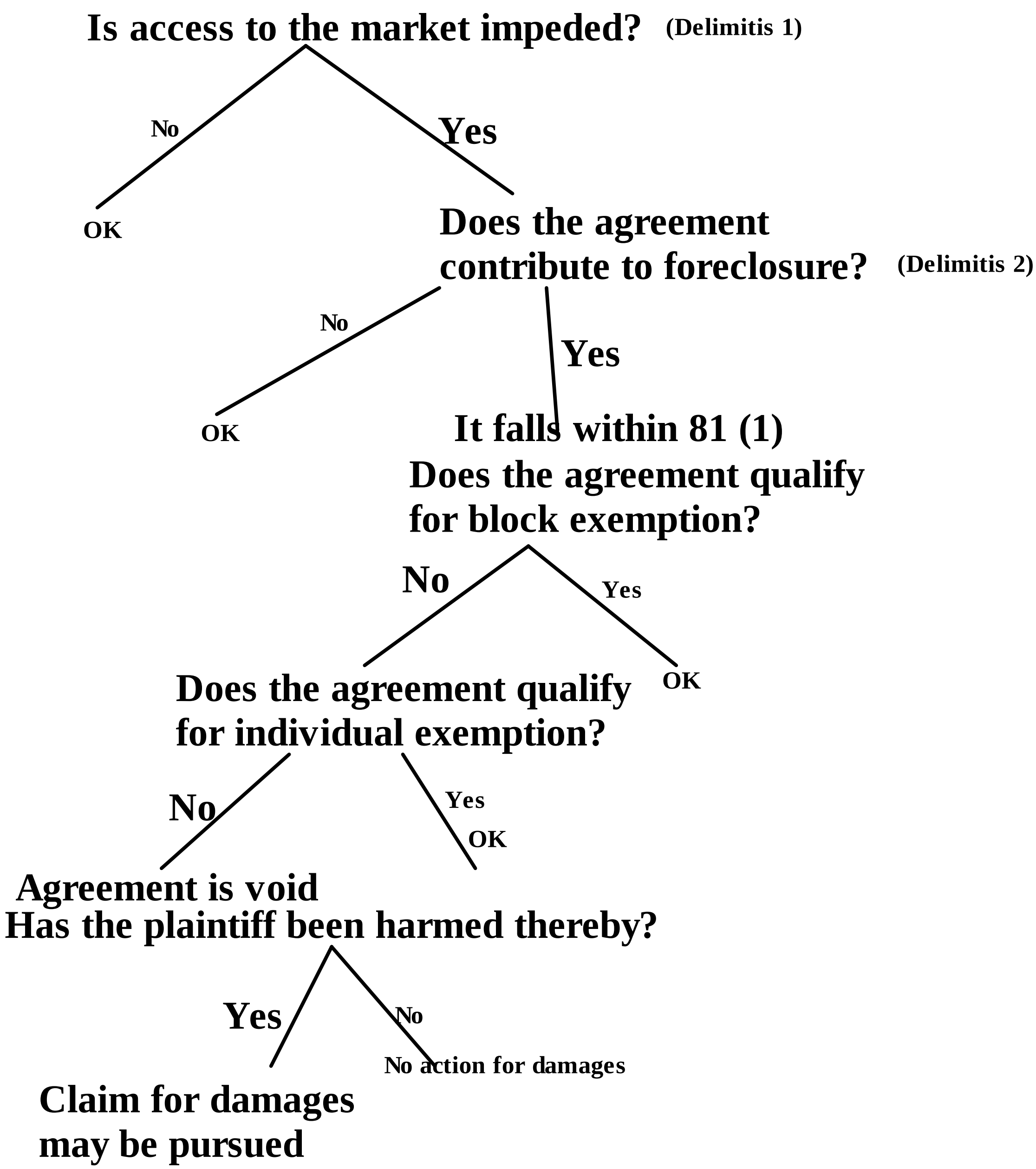

Figure 2: The *Delimitis* “decision tree”

Table 1: Assessing Offsetting Benefits

£/ barrel	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97
Price differential	19	22	26	35	41	45	48
Rent subsidy	16	15	19	23	22	22	24
Value added services	2	2	2	3	7	7	11
Support	2	2	3	3	9	9	9
Promotions	0	1	2	2	3	4	5
(Others not listed)							
Conclusion	3	1	1	-2	3	3	2
Source: European Commission: *Bass*, Table 3							

Table 2: Operation of Retail Outlets

Owner	**Number of pubs**		**Source of beer**
National Brewers	**1988**	**end 1992**	
Allied	6678	4339 (tied)	
Bass	7190	4595 (tied	
Courage	5002	0 (tied)	
Whitbread	6483	4241 (tied)	
S&N	2287	1850	
Regional Brewers			
Greene King	766	851	
Vaux	577	769	
Former brewers			
Grand Met	6419	1650 (managed,free after 1991)	Courage
Inntrepreur		4350 (tied)	Courage
Boddingtons	518	475	
New pubcos			
Pubmaster	466	2026 (including 734 leased from Allied)	
Greenall Whitley	1626	1500	Carlsberg-Tetley

Source: House of Commons Agriculture Committee, fourth report, HCP 402, Session 1992-93. Table 6, pp168-9.
Several other regional brewers, smaller pubcos, and the free trade have been omitted.

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